No. 12721

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

L. P. St. Clair and Annastatia St. Clair,

Appellants,

vs.

United States of America,

Appellee.

REPLY BRIEF FOR APPELLANTS.

Thomas R. Dempsey,
Wellman P. Thayer,
Arthur H. Deibert,
H. Benjamin Thompson,
William L. Kumler,
1104 Pacific Mutual Building, Los Angeles 14,
Attorneys for Appellants.

FILED
MAR 3 1 1950
PAUL P. O'BRIEN,

Parker & Company, Law Printers, Los Angeles. Phone MA. 6-9171.

TOPICAL INDEX.

TABLE OF AUTHORITIES CITED.

Cases.

Miscellaneous

Statutes

Textbooks

No. 12721

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

L. P. St. Clair and Annastatia St. Clair,

Appellants,

vs.

United States of America,

Appellee.

REPLY BRIEF FOR APPELLANTS.

I.

As a Matter of Intention and as a Matter of Law, the 1939 and 1940 Distributions of the St. Clair Estate Company Were Partial Distributions in Complete Liquidation of the Corporation.

(a) *As a matter of law such distributions were liquidating distributions.* From and after the time that the Superior Court assumed jurisdiction in the supervisory liquidation and winding up proceeding all distributions made pursuant to its orders were partial distributions in complete liquidation for under Section 403 of the Civil Code (see Appx. of App. Op. Br.) the Court's jurisdiction was limited to settling claims, determining the relative rights of the shareholders and, "(12) the making of an order, upon the allowance or settlement of the final accounts of the directors, that the corporation has been duly

wound up and is dissolved. Upon the making of such order, the corporate existence shall cease except for purposes of further winding up if needed." "(13) Any and all other matters concerning the winding up of the affairs of the corporation."

As Judge Disney said in his dissenting opinion in *St. Clair Estate Co. v. Commissioner*, 9 T. C. 392 at 417:

> "When we consider the fact that the Superior Court had, on April 20, 1939, ordered that the petitioner's affairs be wound up under the supervision of the court, and that no distribution of assets or property (other than in the ordinary course of business) be made except by order of court, and consider the charges made by Cora as basis for the suit filed, it seems apparent that the superior court, in approving the stipulations of the counsel in the cases that the distributions be made, was clearly, in the order made on December 26, 1939, to distribute 'in amounts up to the net earnings' for 1939, merely setting a limit on amount, and not in fact designating the distributions as out of 1939 income. The company in fact had no $23,000 to distribute out of 1939 earnings, having to borrow $10,000 to make the distribution. The superior court may be presumed to have known that a distribution, in the liquidation it was supervising, was no ordinary dividend, Hellmich v. Hellman, 276 U. S. 233, that distributions are to be regarded as in payment in exchange for the capital stock, and that, after the initiation of dissolution and liquidation, the entire corporate assets became a fund for payment of creditors and stockholders. Therefore, at least as to the distribution in 1939 and the $4,000 distribution 'from income on hand' in October 1940, there is no room for finding or for reasonable inference that the court limited a dividend to

> one derived from current earnings; and, considering the position of the court in the liquidation matter, I think that the other three orders should also be considered as merely designating or limiting the amounts of payment to the amount of 1940 earnings, rather than as designating the distributions as in fact made out of 1940 earnings, so as to enable the petitioner to rely on the orders as proof of that fact. The court had on December 22, 1938, restrained payment of dividends until an accounting should be had. Such accounting was not filed until January 30, 1941. Though the orders allowing distribution, above referred to, were modifications of the general restraining order, I think they were permission to make mere advancements in the process of liquidation, and subject to final accounting, and they do not demonstrate distributions of income of a particular year. Stockholders in a dissolved corporation have no rights except after all debts have been satisfied and their remedy is then in equity. Fletcher Cyclopedia of Corporations, vol. 16, Sec. 8224. The administration of the corporation by the superior court was consonant with such general law."

In so writing Judge Disney was spelling out the federal income tax effect of compliance with the state law, a matter which the respondent asserts was assumed *arguendo* by the majority of the court and concerning which we shall have more to say later. The point is, however, that nowhere in Respondent's Brief has he met or undertaken to meet this point.

(b) *As a matter of intention the distributions of the St. Clair Estate Company here in issue were partial distributions in complete liquidation.* Respondent asserts that it was the intention of the management of the St. Clair Estate Company to pay ordinary dividends (Resp. Br. p. 19). In support of this he points to the court orders directing that distributions be made from "earnings" or "income" of the year, that the distributions were relative to total capitalization small in amounts, that the corporation's capitalization was not reduced on its books, that it did not sell its assets, and that no form 966 was filed pursuant to Section 148, I. R. C. (Br. pp. 16, 17, 22).

As for earmarking the source of distributions, we have pointed out that the sources were in fact exceeded and may for that reason, if no other, be disregarded (App. Br. pp. 28, 29). But putting a name on a distribution or designating the source thereof will not make the difference between an ordinary dividend and a liquidating distribution. (*Hellmich v. Hellman,* 276 U. S. 233; *Tooth v. Commissioner* (C. C. A. 8th, 1932), 58 F. 2d 576; *Canal-Commercial Trust & Savings Bank v. Commissioner* (C. C. A. 5th, 1933), 63 F. 2d 619; *Rheinstrom v. Conner* (C. C. A. 6th, 1942), 125 F. 2d 790; *Gossett v. Commissioner* (C. C. A. 4th, 1932), 59 F. 2d 365; *Rollestone Corp.,* 38 B. T. A. 1093.) In the *Gossett* case the court said in applicable part (p. 367):

> "Certainly at the time of the payment of the dividend in question the corporation was not a going concern, in the legal sense, as its dissolution was

> already under way. It makes no difference what the directors called it when the dividend was declared, nor does the fact that subsequent dividends were termed 'liquidating' dividends when this particular dividend was not so termed after its character. The question of whether it was a 'partial liquidating dividend' is to be determined, not from what it was called, but by the facts as shown by the record. The record shows that it was a very unusual dividend, and entirely outside of the due course of the business of the corporation."

With respect to the size of the distributions, that made in 1939 [$47,000.00, R. 60] was approximately 10% of the corporation's indicated net worth [$476,147.18, R. 78] and that made in 1940 [$26,000.00, R. 61] was approximately 5% of the corporation's net worth. How many corporations conducting business "as usual" distribute 15% of their net worth in two years? The evidentiary statement and the inference drawn by respondent are both wrong.

The fact that the corporation's capitalization was not reduced by book entries and that no certificates were called for cancellation is equally unimportant. (*Holmby Corporation,* 28 B. T. A. 1092, affirmed 83 F. 2d 548 (C. C. A. 9th); *Gossett v. Commissioner* (C. C. A. 4th, 1932), 59 F. 2d 365; *Tooth v. Commissioner* (C. C. A. 8th, 1932), 58 F. 2d 576; *Bacharack,* 29 B. T. A. 282; *Rollestone Corp.,* 38 B. T. A. 1093.) The equivalent of that was done as we pointed out in our brief at page 28 when the Superior Court admonished that any distributions

made pursuant to Court Order should be "charged against said stockholders accounts" and "deducted from or withheld from any moneys or property hereafter payable to said stockholders" [R. 98, 99].

The corporation was a personal holding company. It did nothing but hold investments left to the St. Clair children to invest and reinvest and distribute the net revenue therefrom (Pet. Br. p. 8). As we pointed out (Br. p. 17) it had assets and no liabilities of any consequence and it ultimately distributed its assets in kind. There was no reason for the corporation to sell its assets and for it to distribute cash. The plan of complete liquidation provided for distribution in kind (Br. pp. 16, 17) and it was carried out to the letter. After the plan was adopted the corporation never thereafter did any business. Its activities were then limited under court supervision to preserving the assets for distribution to the stockholders.

Finally the respondent asserts that failure of the corporation to file Treasury Department Form 966 pursuant to Section 148, I. R. C., is fatal. That section requires corporations making distributions in complete liquidation to file Form 966 so advising the Commissioner within thirty (30) days of adopting the plan of liquidation. A search of appellant's records failed to uncover a copy of such a return. But we know of no case where it has been held that failure to file such a return is in any wise fatal to appellant's case and respondent has cited no authority in support of the proposition that it is. The return is

merely an information return to aid in collection of taxes due by *shareholders.* (See Mertens, Par. 48.09.)

As far as intention is concerned, the management of the St. Clair Estate Company had a singular and twofold intention—singular in the sense that they wanted to do everything required of them by law, and twofold in the sense that they had to comply with both the state and federal laws. They were under Cora's proximate guns to comply in the accounting and liquidation proceedings with the state laws, and under the federal government's guns to make distributions or suffer the penalties of personal holding company surtaxes. Their problem was stated and made a matter of record in the minutes of the meeting of the Board of Directors held December 27, 1939 [R. 101-102]:

> "The President further stated, and the Board of Directors unanimously agreed, that pursuant to proceedings commenced and then in progress, all of the assets of the Corporation would have been completely distributed to the persons entitled to thereto during the year 1938 and the Corporation would have been completely wound up and dissolved save for the filing of said legal proceedings and issuance of said restraining order and injunction."

But we submit that there was in this particular no irreconcilable inconsistency in the duties owed the two sovereigns. The management intended to comply with both—neither to the exclusion of the other—and its primary intention was to liquidate and dissolve.

II.

The Tax Court Unanimously Held That the Distributions of the St. Clair Estate Company Made in 1939 and 1940 Were Partial Distributions in Complete Liquidation.

In his brief respondent asserts that appellant misinterprets the Tax Court's holding in *St. Clair Estate Company v. Commissioner,* 9 T. C. 392, in concluding that the Tax Court held that the distributions made by the corporation in 1939 and 1940 were partial distributions in complete liquidation (Resp. Br. p. 23). Such is not the case. The problem before the court in that case was as respondent properly states (Resp. Br. p. 23) to determine whether the corporation was entitled to dividends paid credits for 1939 and 1940. Of course, if the distributions were ordinary dividends there was no question but that the corporation was entitled to the credits necessary and no deficiencies would have been the result (see Sec. 27, I. R. C.). But the respondent took the position that the credits were not allowable because the distributions were partial distributions in complete liquidation not taxable as ordinary income in the hands of the shareholders and therefore no credit applied because no portion of the distributions was properly chargeable to capital account of the corporation.

But the Court did not dispose of the matter by holding that the distributions were ordinary dividends. Rather it cited and applied "Section 27(g), *Distributions in Liquidation*" and "Section 115(c), *Distributions in Liquida-*

tion." Nowhere did it consider or discuss the question whether the distributions qualified as ordinary dividends. Furthermore, the line of cleavage between the majority opinion and the minority opinion regarding the years 1939 and 1940 was with respect to the legal consequence following upon a determination that the distributions were partial distributions in complete liquidation.

If there is room for any further doubt about this point, it should be dispelled by the Court's statement at page 408 as follows:

> "In the instant case we are of the opinion that the *facts*, which we have already related in detail, disclose, beyond reasonable doubt, that the distributions made by petitioner in 1939 and 1940 *were properly chargeable to its earnings or profits to the extent of its stipulated net income for those years.* It is only to this extent that petitioner now claims dividends paid credits on account of the distributions made in 1939 and 1940." (Emphasis supplied.)

That is to say the *facts* required the application of Sections 27(g) and 115(c) both of which apply to liquidating distributions.

III.

The Plan of Complete Liquidation and the Execution Thereof Complied With the Statutory Requirements.

This point we think is adequately covered in our Opening Brief (Br. pp. 20-22), however, the respondent cites two cases which he asserts control this situation and are authority against appellant's views. The first thereof is *Burnside Veneer v. Commissioner,* 167 F. 2d 214, 218 (C. C. A. 6th), which is cited for the proposition that execution of the plan within the three-year period is mandatory. Reference to that case discloses that it involved the tax free liquidation by a parent corporation of a subsidiary corporation under Section 112(b)(6), I. R. C. The case at bar, however, involves the taxable liquidation of the St. Clair Estate Company and the effect of the distributions under Section 115(c), I. R. C. Without going further into the distinguishing facts, unduly lengthening this brief, let us quote from the Tax Court's decision in *George G. Mason,* 3 T. C. 1087, 1091-1092 (Acq. 1944 C. B. 19):

> "It is apparent that the time requirements as to complete liquidation are more flexible in section 115(c) than in section 112(b)(6). Under the former section the plan of liquidation must be adopted in good faith and call for the complete transfer of the property of the liquidating corporation within three years after the close of the year in which the first of the series of distributions is made; while the latter section makes no requirement as to the good faith of the plan, but has a definite and absolute provision that if the transfer is not completed within three years no distribution can be considered as a distribution in complete liquidation. This material differ-

ence between the two sections of the same act, in both 1936 and 1938, one dealing in general with the liquidation of corporations and the other dealing with the liquidation of subsidiary corporations, indicates that Congress deliberately avoided in drafting section 115(c) the inflexible time requirement appearing in the proviso which it added to section 112(b)(6)(D), and that in section 115(c) the legislative emphasis was placed upon the good faith of the plan to complete the liquidating transfers within three years, rather than on the actual completition of the transfers within the specific time limit. Probably Congress had in mind that unforeseeable events might delay the liquidation of a corporation other than a wholly owned subsidiary corporation, even though when the liquidation was started all of the parties concerned believed in good faith and with reason that it would be completed as planned within two or three years.

"In the instant case a plan was adopted in good faith to liquidate the Chesapeake Corporation within three years after the close of the year 1938, when the first distribution was made. At the time the plan was adopted all things pointed to a speedy liquidation. Practically all of the assets were securities and cash, while the corporate liabilities were negligible. Then, over a year after the adoption of the plan, respondent asserted a claim against the corporation in an amount almost equal to the value of all its assets. Until this claim was settled liquidation was impossible. After the claim was settled the liquidation was completed within six months.

"We conclude that where, as in the instant case, there is adopted in good faith a plan of complete liquidation calling for liquidating transfers to be completed within the periods set out in section 115(c),

> and an unforeseen event occurs after the adoption of the plan which makes the completion of the liquidating transfers impossible within the time called for by the plan, there is, nevertheless, a compliance with the provisions of section 115(c)."

The respondent also cites *Heyman v. Commissioner*, 176 F. 2d 389 (C. C. A. 2d). In that case the question was whether the receipt of distributions made by a corporation in 1938 and 1939 to its shareholders were ordinary dividends or liquidating distributions. The corporation, Mideastern Contracting Corporation, had a contract with the City of New York to build a subway. At the conclusion of the contract it had a claim for additional work and materials furnished which was ultimately settled in 1938 and 1939 with additional payments of $66,290.59 and $620,000.00 for those respective years. The corporation, in 1931, adopted a plan of complete liquidation and dissolution and filed its Certificate of Dissolution in 1931. Thereafter, it continued, pursuant to Section 42 of the Delaware General Corporation Law, for the limited purposes of winding up its affairs. By a contract made between the shareholders and the corporation, it was agreed that upon realization of the claim, distribution of the proceeds would be made to the shareholders as "creditors." In their 1938 and 1939 returns, the taxpayer-shareholder reported the proceeds of the claim as capital gain. The Commissioner asserted deficiencies and imposed penalties. The Tax Court held that the purported assignment of

1935 to the "creditors" was a sham and amounted merely to "a transparent subterfuge to evade taxation."

It also held that the proceeds of the claim distributed in 1938 and 1939 was not pursuant to *any* plan of liquidation and for that reason did not qualify as distributions in complete liquidation. The Court of Appeals affirmed the Tax Court's decision. The full text of the applicable portion of the Court's opinion is as follows:

> "We need not stop to point out everything which is lacking to make this the bona fide plan of distribution the statute requires as a prerequisite to treating distributions in installments as distributions in complete liquidation. It is obvious that it was not intended to be one as to the claim for it was a step in the splitting up of the assets following the attempt in 1935 to assign the claim in such a way that it would thereafter be no part of the assets of the corporation. And it is equally obvious that it did not conform to the requirements of the statute. *It came into existence many years after the corporation was dissolved and after some distributions in partial liquidation had been made. It was in reality no plan of complete liquidation at all but merely an agreement by persons who had control of the remnants of the corporate assets concerning the way they should dispose of them.* And, moreover, there was no such time limit as the statute made an essential part of a plan of complete liquidation. The only time fixed for distribution was that it should be after all the liabilities of the company were paid and that they

> should be paid as soon as possible. Thus it is apparent that substantial compliance with the statute was lacking and that the Tax Court correctly recognized that." (Emphasis supplied.)

The Court will observe in the first place that the decisions cited by appellants (Br. pp. 20-21) were decisions of the Tax Court. We call attention to the fact that in *Heyman v. Commissioner, supra,* the Court of Appeals *affirmed* the Tax Court's decision which applied the same rule as the cases cited by appellants. The case is not applicable in the first place because in the case at bar there *was* a plan of complete liquidation which was never changed and was followed to the letter. Furthermore, in the case at bar the plan was to distribute the assets "forthwith" and at the time the plan was adopted the corporation's total liabilities amounted to only $498.35 [R. 78]. Finally, the issue is one of fact. The Tax Court and the Court of Appeals rightly held that under all the peculiar circumstances attendant in the *Heyman* case, there was no bona fide plan to liquidate within three years, but in the case at bar the bona fides of the plan adopted prior to the issuance of any injunction, calling for a distribution "forthwith" can not be challenged and we submit that the plan meets the statutory test.

IV.

Section 115(g), I. R. C., Has No Application to the 1939 and 1940 Distributions of the St. Clair Estate Company.

In our opening brief we have reviewed at length the adoption and execution of the plan of complete liquidation of the St. Clair Estate Company (Br. pp. 15-24). Suffice it to say for this purpose that there is no justification whatsoever for any inference that the distributions here involved were made as a subterfuge for tax evasion purposes and consequently Section 115(g) has no application.

When that section was enacted in the 1926 Act the statement of the Managers on the part of the House declared in applicable part (Conf. Rep. 356, 69th Cong., 1st Session, p. 30):

> "Amendment No. 1: It has been contended that under existing law a corporation, especially one which has only a few stockholders, might without resorting to the device of a stock dividend be able to make a distribution to its stockholders which would have the same effect as a taxable dividend. For example, assume that two men hold practically all the stock of a corporation, for which each had paid $50,000 in cash, and the corporation had accumulated a surplus of $50,000 above its cash capital. It is claimed that under existing law the corporation could buy from the stockholders for cash one-half of the stock held by them and cancel it without making the stockholders subject to any tax, yet this action in all essentials would be the equivalent of a distribution

through cash dividends of the earned surplus. Section 201(g) of the House bill rewrites the provision of the existing law to make clear that such a transaction as above indicated is taxable. *Obviously this subdivision does not apply in cases of a complete liquidation of all the stock of the corporation, or to one of a series of distributions in a complete liquidation which is bona fide carried out.* This amendment provides that in the case of the cancellation or redemption of stock not issued as a stock dividend this subdivision shall apply only if the cancellation or redemption is made after January 1, 1926; and the House recedes." (Emphasis supplied.)

Commenting on the application of this section Mertens Law of Federal Income Taxation states (Vol. 1, p. 633, Sec. 9.121):

"The provision relating to distributions equivalent to a dividend was intended to prevent circumvention of the surtax through employment of the forms of partial liquidation. The courts and the Board have accordingly held that, although the provision relating to distributions essentially equivalent to a dividend is on its face open to the interpretation of being applicable to any distribution in cancellation or redemption of stock where earnings or profits exist, it is nevertheless to be construed in the light of its history as aimed at tax avoidance and accordingly limited in its applicability to those situations where the circumstances justify the conclusion that a purpose existed to distribute earnings or profits in the guise of a partial liquidation."

Without laboring this brief further, we respectfully submit that the stipulated facts offer no justification for an inference that there was a purpose to evade taxes in

making the distributions of 1939 and 1940. The decision of the trial court is clearly erroneous and should be reversed with a direction to enter judgments for the appellants as prayed.

Respectfully submitted,

THOMAS R. DEMPSEY,
WELLMAN P. THAYER,
ARTHUR H. DEIBERT,
WILLIAM L. KUMLER,
H. BENJAMIN THOMPSON,

Attorneys for Appellants.